



KENTUCKY RETIREMENT SYSTEMS

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Representative Brent Yonts
Capitol Annex, Room 366A
702 Capitol Avenue
Frankfort, KY 40601

Dear Representative Yonts:

The purpose of this letter is to convey to you the Kentucky Retirement Systems' (KRS) comments on the impact or potential impact of the Senate Bill 2 (SB 2)¹ proposals on KRS' operations.

Before addressing the specific provisions of SB 2, I want to confirm that KRS' Board of Trustees is dedicated to administering the pension system in a manner that is consistent with the Board's fiduciary duty, embodies the highest ethical standards, emphasizes transparency, is effective and efficient in order to maximize the benefit to its membership and the Commonwealth as a whole. Consistent with the Board's goal of ethical, efficient, and effective administration, when legislation is proposed that will negatively impact the administration, benefits, or stability of the pension funds, the Board is obligated to advise the Governor and the General Assembly of the negative impact of the plan sponsor's proposal. Unfortunately, while there are provisions in SB 2 that the Board does not think will negatively impact the Systems, several provisions will make the Systems less efficient, less competitive, and will result in the expenditure of additional funds at the very moment that KRS' constituency has asserted that the General Assembly should be taking all possible actions to maximize the Systems' financial stability.

KRS' concerns with SB 2 are as follows with the various proposals addressed by reference to SB 2 section numbers.

Section 2 (1)(e)

Senate confirmation of six (6) appointed KRS trustees.

Currently, Kentucky's Governor appoints six (6) KRS trustees who serve four (4) year terms that begin either on April 1 or July 1 following the expiration of a term. Pursuant to Senate Bill 2 passed during the 2013 regular session, three (3) of the Governor's appointees are required to be made from lists of nominees submitted by the Kentucky Association of Counties, the Kentucky League of Cities and the Kentucky School Boards Association. The terms of the appointed

¹ SB 2 w/ SCS1, SFA1, SFA2, SCTA1

trustees expire in different years. Current terms will expire in 2016 (2 trustees), 2017 (3 trustees) and 2019 (1 trustee). Each of the KRS trustees serve on 2-3 board committees in addition to serving on the full board.

If Senate confirmation of appointed trustees is required, there is a potential for significant disruption of KRS board and committee operations and continuity on the board would be adversely affected with a resultant loss of important knowledge and experience. For example, it is very possible that three (3) trustees could be appointed to begin serving on July 1 of a year and one (1) or more of them could be required to vacate the position nine (9) months later at the conclusion of a legislative session, if the appointments are not confirmed. One (1) or more Board positions would then remain vacant for a period and the appointment process and confirmation process would have to be repeated.

Section 2 (9)(a)

Senate confirmation of the KRS executive director.

The comments above regarding the potential for disruption of KRS operations and the adverse impact on board continuity as the result of a board member confirmation process are also applicable to the proposal to subject the appointment of the KRS executive director to Senate confirmation. The executive director is currently appointed by the KRS Board of Trustees to act as the Board's chief administrative officer. When it has been necessary to fill the position of executive director, it has been the practice of the KRS board to conduct a nationwide search utilizing the services of a reputable and experienced executive search firm that is hired following a Request for Proposal (RFP) process. The requirement of Senate confirmation would have the potential to unnecessarily politicize the process and cause significant disruption, if an appointee is not confirmed and the hiring process, which could take many months, must begin anew.

Section 2 (1)(e)5e and f.

Revision of "investment experience" definition.

The proposed change in the definition of "investment experience" will tend to limit the Governor's ability to appoint qualified persons to the KRS Board. Although additional investment experience on the board is certainly desirable, it may be difficult to find working investment professionals who have the available time to devote to KRS Investment Committee and board meetings, unless they are retired. If a working investment professional is appointed to the board, there is also a significant potential for conflicts of interest given the wide-ranging and comprehensive nature of the KRS investment program. An alternative might be the creation of an investment advisory group that would advise the KRS Board of Trustees, the Public Pension Oversight Board and others, much like the Consensus Forecasting Group advises the state budget office and LRC regarding revenue forecasts.

Section 2 (2)(d) and (f).

Application of the Kentucky Model Procurement Code and KRS Chapters 56 and 57 to KRS.

These changes will subject KRS to the Kentucky Model Procurement Code (MPC) under Kentucky Revised Statutes Chapter 45A for all purchases of goods and services. The KRS Board and staff currently operate under a Procurement Policy adopted by the KRS Board which mirrors in most respects the MPC, but is designed to allow KRS to address the specific needs of the pension system. For instance, KRS uses a public Request for Proposal (RFP) process to purchase all goods and investment consulting, actuarial, auditing, medical, insurance and other technical and professional services, when the cost of such goods or services is expected to be \$40,000 or more in a fiscal year. Therefore, this amendment would not improve KRS' contracting practices because they already embody the intent of the code by ensuring an open and competitive contracting process resulting in KRS paying a fair price for the services provided.

The proposed amendment is apparently also intended to require KRS to use an RFP process to hire investment managers. While an RFP process may be ideal to purchase paper or computers, it is not good investment practice to choose managers proposing the lowest cost, rather investors must choose managers based upon their ability to perform. KRS currently has contracts with over 100 investment managers. These contracts are entered into after an extensive consulting and due diligence process by KRS investment staff and nationally recognized investment consultants that identify desirable investments that fit into needs of KRS' investment portfolio. KRS' due diligence process is set forth in its Investment Policy Statement that is developed by the KRS Investment Committee and ratified by the full KRS Board. All investment managers hired by KRS are approved at a public meeting by the KRS Investment Committee after staff and consultant have either jointly or separately made a recommendation to the Investment Committee regarding that specific manager.

If KRS is required to utilize an RFP process to hire an investment manager, it will cause extensive delays and increased administrative costs. Rather than focusing on a few quality managers that have been identified after careful research by KRS staff and KRS investment consultant, the staff and investment consultants will have to review and score numerous RFP responses that may be submitted by managers that are not qualified. More importantly, KRS might be forced into contracting with investment managers against the advice of its internal investment staff, as well as external investment advisors. Put simply, KRS Chapter 45A was not designed for the investment of billions of dollars of trust assets and will significantly diminish KRS' ability to meet its assumed rate of return.

Finally, subjecting KRS to the requirements of Kentucky Revised Statutes Chapters 56 and 57 would introduce several inconsistencies between how KRS Chapter 18A finance agencies are run

and how KRS' enabling statutes are set up. These inconsistencies would have to be resolved or amended by subsequent legislation. These changes would likely result in a significant interruption of business until KRS and Finance can determine how to implement the new requirements and procedures. For example, Chapter 57 contains provisions regarding document printing. Provisions of this section may require the Governor, or designee, to pre-approve KRS publications and mailings and establish additional rules regarding printing materials. Also, Chapter 56 contains provisions regarding state property. It is unclear at this time what effect, if any, these provisions would have on KRS.

Section 2 (9)(b) and (c)

Subjecting KRS to the Chapter 18A State Personnel System

Prior to December 1, 2002, KRS' personnel were employed pursuant to the provisions and processes set forth in Kentucky Revised States Chapter 18A as administered by the Kentucky Personnel Cabinet. The following is representative of the basic process under the 18A system:

A new or vacated non-classified/non-merit position:

- *The Governor's Office is notified of the opening*
- *KRS attaches any resume's/information*
- *The Governor's Office approves or disapproves filling the opening*
 - ❖ *The last KRS attorney hired in this manner accepted the position, but had to wait approximately 3 months for the Governor's Office to issue an Executive Order approving the hire.*

A new or vacated classified/merit position:

- *KRS prepared a description and sent a request for the register to Personnel*
- *KRS post the position internally and qualifies any internal employees*
- *KRS posts the position*
- *Personnel Cabinet administers tests, pre-qualifies external applicants*
- *The job classifications and salary range is set by the Personnel Cabinet*
 - ❖ *Resulted in a large number of employees being misclassified (i.e., an "Investment Accounting Specialist" actually performing HR payroll functions.)*
- *The Personnel Cabinet follows through on any Americans with Disabilities Act issues, and other compliance matters*
- *The Personnel Cabinet made final hiring/promotion determinations irrespective of KRS business needs, performance, or qualifications.*

As a result of rising pension system membership and changing membership demographics, KRS' Board of Trustees undertook a fiduciary review to ensure they were acting in the best interest of the Systems' membership and beneficiaries as well as prepare the Systems for foreseeable challenges in the future. One of the shortcomings identified by the fiduciary review and noted to be an obstacle in the path of the Board fulfilling its fiduciary duty was staffing through the Commonwealth's 18A merit system. Public pension plans such as KRS are separate and distinct from other state agencies because of the fiduciary duties to the membership, rather than the state as a whole. Consequently, nationally recognized uniform standards² have recommended that administration must be separated to avoid actual or perceived conflicts of interest.

The unique operations of KRS were restricted by the 18A classification and compensation system. For many KRS positions, there were no comparable classifications in state government and the other major statewide retirement system, Kentucky Teachers' Retirement System, was an independent agency. Consequently, KRS could not design a classifications and compensation structure consistent with the unique duties that KRS' employees performed.

The limitations created by the 18A classification and compensation system had an impact on member retirement administration and customer service. For example, KRS 61.690 mandates that a member who files a retirement application be provided an estimate of his monthly benefit within ten days of receipt of the application. In order to meet that statutory deadline for service and other business needs, counselors at the time were working a combined average of 680 hours of overtime per month. Once the retirement applications were processed, the retiree's benefits must be set up in the payroll system to issue the monthly retirement benefit. To ensure that new retirees will received their retirement benefits on time the Systems' Retiree Services Division were working more than 500 hours of overtime per month at the time. Moreover, as a result of the large number of retirements and other requests, such as service purchase costs, installments, transfer and rollovers, KRS was 3-4 months behind on filling these requests.

The issues and challenges described above had a significant impact on KRS' ability to attract and retain staff under the 18A classification and compensation system. At the time significant numbers of trained KRS staff left KRS to seek more desirable positions with less demanding workloads and/or greater pay at KTRS³ or elsewhere in the Commonwealth's Personnel Systems. These defections came after KRS invested a minimum of 6 to 8 months to adequately train a retirement counselor. KRS' turnover numbers from calendar years 1999 and 2000 are set forth below.

² UMPERSA, Uniform Management of Public Employee Retirement Systems Act.

³ KTRS Salaries were on average 45% higher.

1999 14.9% Overall turnover (191 Total Positions)
50.0% Employer Reporting and Education
12.5% Benefits Counselors
36.4% Call Center Counselors
50.0% Insurance Counselors

2000 24.9% Overall turnover (191 Total Positions)
66.6% Employer Reporting and Education
58.3% Benefits Counselors
23.1% Call Center Counselors
75.0% Insurance Counselors

Eventually, the identified resolution of KRS staffing concerns was to remove KRS from the Commonwealth's merit system and create a KRS specific system with similar merit protections, benefits, and leave, but designed to meet the needs of the pension system. Moreover, a KRS specific personnel system allowed for a classification and compensation systems that is based upon and rewards performance, as opposed to longevity, a known shortcoming of the Commonwealth's personnel system.

KRS' personnel system limitations were eventually addressed in HB 309 (2002 Regular Session), which amended KRS 61.645 to provide for KRS' Board of Trustees to establish and administer an independent personnel system. In the years following the passage of HB 309, KRS has slowly been able to stabilize its workforce, build expertise amongst its staff, modernize its administration of benefits, and provide a higher level of service to its constituents. KRS' independent personnel system has allowed it to react appropriately to membership roles that have basically doubled since 1993⁴ and significant legislative changes such as HB 1 in 2008 and SB 2 in 2013.

Finally, KRS has implemented its personnel system over the past 13 years with the acquisition of expensive and complex software systems designed to meet its unique needs. A return of KRS to the 18A personnel system will eliminate the use of these systems to some extent and require KRS to report through the State KHRIS system. Both the current KRS systems and the KHRIS system would have to be reprogrammed to create an interface. It is anticipated that it will take KRS and the Personnel Cabinet many months at significant cost to recode the systems to handle KRS personnel.

⁴ Growth in active membership (Approximately 116,000 in 1993 to approximately 136,000 as of 06/30/2015; Growth in inactive membership (Approximately 28,000 in 1993 to approximately 121,000 as of 06/30/2015; Growth in retired membership (Approximately 36,000 in 1993 to approximately 97,000 as of 06/30/2015.)

In conclusion, KRS' removal from the 18A classification and compensation system has overall been very positive. Proposals that are enacted without due thought or impact analysis risk undermining all the positive progress that has been made since 2002 and may paralyze KRS going forward. Without a competitive and flexible personnel system that can react to the ever changing retirement administration landscape KRS will be unlikely to fulfill its fiduciary duties to its members and beneficiaries in the future.

Section 2 (19)(i)

Disclosure of investment fees and commissions.

KRS has been and will continue implementing a program to fully disclose all investment holdings, fees and commissions by asset class and by individual investment manager. However, in the case of certain asset classes, underlying fund of fund fees and holdings may not be obtainable. Further discussion of the way this provision is worded is necessary to avoid establishing a requirement that is not possible to meet.

Section 2 (19)(l)

Subject KRS contracts and offering documents to review by the Contract Review Subcommittee and the Auditor of Public Accounts.

This provision has the potential to create significant disruption and delays in KRS' operations, particularly its investment function. Furthermore, the Contract Review Committee process under KRS 45A.705 usurps the authority of the 13-member KRS Board of Trustees by placing ultimate authority with the Secretary of the Finance and Administration Cabinet to determine whether a contract shall be revised to comply with Contract Review Subcommittee objections, or canceled, or remain effective. This in effect gives one KRS Board of Trustee member the ability to control KRS contracting.

Section 2 (21)

Prohibition on the payment of KRS funds to any placement agent.

KRS has no problem with this requirement. KRS has a comprehensive placement agent disclosure policy and has not approved payment of any funds to a placement agent since 2009.

Section 3 (1)(d)

Application of ethics codes and codes of professional conduct to KRS employees, trustees, investment advisors and investment managers.

KRS has no problem with this requirement. However, it should be noted that requiring external investment managers to adopt additional codes of ethics (in addition to the Investment Advisers Act code of conduct) in contracts or investment side letters may be resisted and may result in the loss of some investment opportunities if an investment manager will not agree.

In conclusion, it is KRS' position that several of the provisions of SB 2, as outlined above, have the potential to create very significant operational disruption, delays, inefficiencies and increased administrative costs. These proposals have not been sufficiently examined to determine their necessity and the full range of impacts that they may have on the operations of KRS. It is our position that these proposals should be referred to the Kentucky General Assembly's Public Pension Oversight Board so that they may be further discussed and fully analyzed regarding their impact on KRS.

If you have any questions regarding the contents of this letter or wish to discuss the issues in more detail, please do not hesitate to contact me.

Sincerely,



William A. Thielen
Executive Director

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